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# The Antitrust Counselor

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## *Antitrust Counseling on Bundling in High-Technology Industries*

By Karen A. Gibbs and Thy B. Bui

Courts have struggled to define a workable test for determining when bundled discounts violate the Sherman Act. Bundling, as used in the antitrust context, is commonly understood as the practice of offering two or more goods or services together that could be sold separately. A bundled discount occurs when a bundle of goods or services is sold for a lower price than the seller charges for goods or services purchased individually. Bundled discounts can raise antitrust issues when a monopolist offers significant discounts on a bundle that includes its monopoly products or services in order to induce customers to purchase its non-monopoly products (potentially foreclosing competition from others selling the non-monopoly product).

The Antitrust Modernization Commission (“AMC”) proposed a three-part test for analyzing bundled discounts under the antitrust laws:

To prove a violation of Section 2, a plaintiff should be required to show each one

of the following elements (as well as other elements of a Section 2 claim): (1) after allocating all discounts and rebates attributable to the entire bundle of products to the competitive product, the defendant sold the competitive product below its incremental costs for the competitive product; (2) the defendant is likely to recoup these short-term losses; and (3) the bundled discount or rebate program has had or is likely to have an adverse effect on competition.

See *Cascade Health Solutions v. PeaceHealth*, 502 F.3d 895 (9th Cir. 2007), *superseded and amended by* 515 F.3d 883 (9th Cir. 2008). In *PeaceHealth*, the Ninth Circuit adopted the first prong in the AMC’s three-prong standard as its own test for determining when a bundled discount constitutes anticompetitive conduct in violation of Section 2 of the Sherman Act.

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*Id.* at 900. As explained by the court: “Under [this] standard, the full amount of the discounts given by the defendant on the bundle are allocated to the competitive product or products. If the resulting price of the competitive product or products is below the defendant’s incremental cost to produce them, the trier of fact may find that the bundled discount is exclusionary for the purpose of [Section] 2.” *Id.* at 906. The products at issue in *PeaceHealth* were health care services.

The court in *Meijer* reasoned that the *PeaceHealth* test may not make sense when applied to high-tech industries where fixed costs are often high due to R&D costs, but the incremental cost for the manufacturing of each pill is low.

Although *PeaceHealth* provides a framework for analyzing bundling, a recent Northern District of California court held that *PeaceHealth* does not require that framework to be used in all cases. In *Meijer, Inc. v. Abbott Laboratories, Inc.*, No. C 07-5985 CW (N.D. Cal. April 11, 2008), in fact, the court rejected *PeaceHealth*’s discount attribution test because the products at issue, HIV medications, involved high fixed costs and low incremental costs.

In *Meijer*, the plaintiffs alleged that the defendant, Abbott Laboratories, violated Section 2 of the Sherman Act by bundling two drugs. Abbott manufactures the protease inhibitor Norvir, which is mainly used as a “booster” to boost the effectiveness of other protease inhibitors. Abbott also produces Kaletra, a “boosted” protease inhibitor that combines Abbott’s Norvir with its other protease inhibitor, lopinavir. *Meijer* accused Abbott of leveraging its monopoly power in the “booster” market, which consists only of Norvir, to seek a monopoly in the “boosted” market, “which is

comprised of drugs intended for use with Norvir as a booster.” *Meijer*, slip op. at 7. Specifically, plaintiffs alleged that Abbott engaged in anticompetitive conduct when it “raised the wholesale price of Norvir by 400 percent while keeping the price of Kaletra constant,” after two other protease inhibitors were introduced to the “booster” market. *Id.* at 4.

In its motion to dismiss, Abbott argued that the plaintiffs could not meet the standard set forth in *PeaceHealth*, since they could not demonstrate that the resulting price of lopinavir, after allocating the bundled discount, \$1.64, was less than Abbott’s average variable cost to produce it, “likely only a few cents per pill.” *Id.* at 14. The court, however, declined to apply the “discount attribution” standard, explaining that the *PeaceHealth* court’s rationale in adopting the test justified refraining from using it in that case. The court in *Meijer* reasoned that the *PeaceHealth* test may not make sense when applied to high-tech industries where fixed costs are often high due to research and development costs, but the incremental cost for the manufacturing of each pill is low.

The *Meijer* court emphasized that *PeaceHealth* itself “implicitly acknowledges that some atypical cases may fall outside of the situation where only below-cost pricing will have the effect of inhibiting competition.” *Id.* For support, the court pointed to the *PeaceHealth* court’s discussion of *Brooke Group, Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993), where the *PeaceHealth* court “noted that the Supreme Court has never gone ‘so far as to hold that in every case in which a plaintiff challenges low prices as exclusionary conduct the plaintiff must prove that those prices are below cost.’” *Meijer*, slip op. at 4.

The *Meijer* court went on to conclude that “the stated goal of the [*PeaceHealth*] rule – making unlawful only pricing that would exclude equally efficient competitors from the market – would not be served by applying the rule here.” *Id.* If the *PeaceHealth* rule were applied, Abbott’s bundled discount would not be an antitrust

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violation and competitors would have to sell an equally effective product for the same price as Abbott's cost to manufacture lopinavir, which was only a few cents per pill. But "no newly developed PI could ever be sold profitably at such a price, because the manufacturer would never be able to recoup its huge research and development costs." *Id.* at 14-15. Thus, the court concluded that in the context of the pharmaceutical industry, where fixed costs "dwarf variable costs," the *PeaceHealth* rule "does not achieve its stated goal of prohibiting pricing that results in the exclusion of equally efficient competitors" and should not be applied. *Id.* at 15. The *Meijer* court recently approved the decision for interlocutory appeal to the Ninth Circuit.

### Counsel for clients in the pharmaceutical and high-technology industries should be especially cautious in relying on *PeaceHealth*.

Given *Meijer*, antitrust counsel considering relying on *PeaceHealth* to justify bundled discounts have an added issue to consider. Counsel for clients in the pharmaceutical and high technology industries should be especially cautious in relying on *PeaceHealth*. Antitrust counsel may need to consider the cost structure of the particular industry in which they are working. Transparent tape, for example, may not have high fixed costs if there is relatively little research and development involved. Even after the total bundled discount is allocated to a product like tape, as long as the resulting price is above the incremental cost of manufacturing additional tape, a competitor should still be able to compete effectively even if it does not recover all of its fixed costs.

In contrast, where a product — like the pharmaceuticals at issue in *Meijer* — requires costly research and development over a period of years, a rival manufacturer may not realistically expect to stay in business if it is unable to factor its fixed costs for research and development into the price of its product. Consequently, in those industries with high fixed costs, there is a risk that the *PeaceHealth* test might not apply to litigation over the bundled discounts since it would potentially allow dominant firms to exclude new competitors in other markets through the use of bundled discounts that make it impossible for the competitor to compete on price.

Accordingly, in-house and outside antitrust counsel in high-tech industries should carefully consider the ramifications of the *Meijer* decision on the legal standards that might apply to bundled discounts in their industries. Of course, counsel will also need to consider fully how courts outside of the Ninth Circuit may approach this high-fixed-cost issue.



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